VZCZCXRO2972
RR RUEHCN RUEHGH
DE RUEHGH #0201/01 1200857
ZNR UUUUU ZZH
R 300857Z APR 09
FM AMCONSUL SHANGHAI
TO RUEHC/SECSTATE WASHDC 7902
INFO RUEHBJ/AMEMBASSY BEIJING 2758
RUEHGZ/AMCONSUL GUANGZHOU 0418
RUEHSH/AMCONSUL SHENYANG 1953
RUEHCN/AMCONSUL CHENGDU 1962
RUEHHK/AMCONSUL HONG KONG 2130
RUEHIN/AIT TAIPEI 1749
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RHEHAAA/NSC WASHINGTON DC
RUEHGH/AMCONSUL SHANGHAI 8547

UNCLAS SECTION 01 OF 05 SHANGHAI 000201

SENSITIVE
SIPDIS

TREASURY FOR OASIA/INA/HAARSAGER AND WINSHIP
DEPT FOR EAP/CM, INR/B, EEP/TRA/AN
USDOC PASS BUREAU OF ECONOMIC ANALYSIS
USDOC FOR ITA DAS KASOFF, MELCHER, SZYMANSKI
STATE PASS USTR FOR STRATFORD, WINTER, TWINELAND
NSC FOR LOI, SHRIER

E.O. 12958: N/A
TAGS: ECON EFIN PGOV ETRD ELAB KTEX CH
SUBJECT: STIMULUS PROVIDES LIFELINE TO CHINA'S TEXTILE AND APPAREL INDUSTRY

¶1. (SBU) Summary: Government stimulus policies have saved thousands of apparel manufacturers in East China from shutting down production as dramatic drops in volume, sharp price cuts and RMB appreciation erode profit margins. During a series of meetings with Yangtze River Delta (YRD) apparel and textile executives and Chamber of Commerce officials the week of April 13th, Conoff explored the effects of recent stimulus measures on the industry. According to textile industry representatives, tax rebates, loose credit policies, and lenient application of labor laws are keeping a major percentage of the industry's 25 million employees at work. In addition, YRD manufacturers, who account for half of China's total textile and apparel exports, are able to remain competitive and stay in business. Although the stimulus provides short-term relief from the global economic downturn, industry insiders voiced concern about the long-term viability of the industry. Company leaders and Chamber of Commerce officials believe that the industry requires additional stimulus and expressed relief that Chinese Premier Wen Jiabao recently expressed his willingness to "use every possible means" to support export growth. End Summary.

Central Government's Commitment to Save "Pillar Industry"

-- ------------

¶2. (SBU) Until recently the Chinese Government encouraged manufacturers to move away from textile and apparel, industries traditionally considered too labor-intensive and low-margin to fuel the higher value-added production that Chinese officials hope will drive China's economy in the future. Despite this, Zhang Tao, a Textile Industry Chamber of Commerce (CCOIC TEX) official, estimates that China's 450,000 textile and apparel manufacturers have seen their business volume triple in the last ten years. The sector now provides jobs for 25 million direct and 100 million indirect employees and is considered a key element of China's economic growth and social stability. Although exact statistics are difficult to obtain from the government, industry insiders believe that in the recent past, 10 percent of the industry's factories have shut down in

Zhejiang Province, where 40 percent of the economic output comes from textile and apparel manufacturing, and claim that an even higher percentage of textile and apparel manufacturers in southern China have closed. In response, Premier Wen Jiabao declared in late 2008 that textiles and apparel are a "pillar industry" and committed government support to revitalize the industry.

Companies Plagued by Weak Orders, Low Prices and No Profit

-- -------------

¶3. (SBU) Vice President Hong Xuechun from Zhejiang Orient, a holding company with USD 500 million annual sales and 16 subsidiaries, reports that plummeting orders are the biggest problem the industry faces. Hong and executives from the company's 5 largest subsidiaries explained that for the past several years annual sales grew by 15-20 percent, but in 2008 orders were flat. According to statistics released by Xinhua news agency, China-wide textile and apparel exports still grew in 2008 by 8.2 percent, a much slower rate than 2007's 18.9 percent growth. The first quarter of 2009 has been extremely difficult for the industry as textile exports fell 15 percent and apparel exports dropped 5 percent year-on-year. According to Leonard Liu, Vice General Manager of Garmtex, which sells apparel to major US retailers including Macy's, volume drops of this size have a devastating effect in an industry with relatively low profit margins. Liu estimated that in the YRD, 5

percent net profit is considered healthy for apparel companies and even less is acceptable for a textile manufacturer. Higher-end manufacturers have not been protected by larger margins because their sales volume plunged faster than the industry average. DZ Group executive Lilian Song, explained that because her company supplies high-end goods to upscale retailers such as Nordstrom and Land's End, they suffered a 30 percent drop in sales in 2008 and expect another 30 percent fall in 2009.

¶4. (SBU) The economic downturn has decimated profits for an industry that accounted for USD 185 billion annual sales in ¶2008. U.S. buyers, facing the weakest retail environment in decades, are now reluctant to invest significant amounts into one style before it has been market tested. Accordingly, they have cut order sizes by as much as 50 percent, making it difficult for manufacturers who depend on large scale factory runs to make a profit. At the same time, increasing competition for fewer orders has led to a sharp drop in the price manufacturers receive. According to Ningbo Seduno Group General Manager Xu Jianchang, whose company has 3,500 employees and USD 180 million annual export sales, prices have dropped 10 percent on average since the beginning of the economic downturn. Unfavorable RMB exchange rates have further eroded profits. Song from DZ Group clarified that her company's profit levels have decreased from 30 percent in the 1980s, 15 percent in the 1990s, 8 percent from 2000-2007, to 5 percent in 2008 and most likely 0 percent in 2009.

Rebates Sustain Ailing Companies

¶5. (SBU) Export tax rebates are the key component of the government's stimulus plan to support textile and apparel exports. In an attempt to reduce exporter's costs, the Ministry

of Finance started raising the export tax rebate in August 2008. Since then, in a series of unprecedented moves, the rate has jumped from 11 percent to 16 percent, its highest level in 10 years. Sun Ting from China Council for the Promotion of International Trade (CCPIT) Ningbo Information Department explained that when exports weakened, industry officials immediately lobbied for this reform because they regard export tax adjustment as the most efficient stimulus the government can provide to their industry. CCPIT Hanghzou official Chen Jiyang stated that the increase has an enormous impact and that "if you don't have the refund, you can't run a business because there is currently no profit in foreign trade." One Citic securities analyst cited in the press estimates that each 1 percent increase in the rebate tax adds several billion RMB of profits to the industry. Seduno Group General Manager Xu agreed that the rebate has helped him to be more competitive by allowing him to lower unit sales price.

New Bank Lending Keeps Companies Solvent

¶6. (SBU) Another key measure of the stimulus plan is increased liquidity for apparel and textile small- and medium-sized enterprises (SMEs). In the past, SMEs have struggled to obtain capital from Chinese banks that are reluctant to lend to apparel and textile manufacturers. Seduno Group General Manager Xu estimates that 60 percent of the SMEs in Ningbo are currently using this new liquidity to stay in business. Nonetheless,

Chairman and General Manager of Flying Horse, a subsidiary of industry giant Shanghai Knitting Company, Lu Longsheng, believes that many companies still face difficulty obtaining loans. Lu described how Shanghai based SMEs are creating alliances in which they approach banks as a group and provide guarantees for each other. He also described a new phenomenon where executives request that banks allow them to mortgage their personal homes to obtain operating funds. Zhejiang Orient Senior Vice President and Finance Director Jerry Zheng, described how even his company, an extremely well capitalized former state-owned enterprise, faces cash flow challenges. Well known U.S. retail customers are all demanding longer settlement terms of 60 days instead of the traditional 45 days. In this volatile environment, a cancelled order after production is complete or the bankruptcy of a buyer can trigger serious cash flow problems and force companies to cease operations.

Economic Downturn Undermines Worker Protections
-- --

¶7. (SBU) In order to avoid massive layoffs, government officials are rolling-back several of the key measures put in place by the 2008 Labor Law. DZ Group Human Resources Manager Lilian Song explained how the Shanghai government allows companies that are suffering economic losses to postpone the payment of new social insurance requirements which comprise 42 percent of the company's total wage costs. CCOIC Tao defended the law as "a good law, but one that adds a burden to the operations of manufacturers." However, Mrs. Song argues that the law hurts the industry by driving wages up 15 percent. She added that the minimum wage and overtime regulations are unevenly enforced. General Manager of Flying Horse Lu explained how the local government in the Minhang District of Shanghai is following the central government directive to avoid layoffs by providing grants that fund alternative training for idle workers. CCPIT Ningbo official Liu Yanlan considers that the

relaxed application of the law is "very helpful, it allows companies to hold onto money and fund cash flow and operations." However, despite these initiatives to keep workers employed, with production facilities running at 50-70 percent of capacity, even industry giant Zhejiang Orient executives admitted that, although they had not yet cut staff, they are now "seriously considering it."

Government Support for Brands Less Helpful to East China's SMEs

--- ------------------

¶8. (SBU) In an attempt to revitalize the industry and help companies move higher up the value chain, the government introduced measures that fund marketing and production costs for Chinese brands. The government's stimulus plan encourages manufacturers to shift their operating model from an export-driven model to a domestic sales model so that local brands can benefit from the 30 percent annual growth in China's apparel market. CCPIT Ningbo official Sun Ting estimated that 90 percent of Zhejiang's apparel and textile manufacturers' production is focused on foreign trade. Ting explained that although Zhejiang has a reputation as one of the most entrepreneurial environments in China, local SMEs are not capturing any benefit from this government program. For example, Seduno Group General Manager Xu explained that selling to the Chinese market is "totally different, with different rules" and that his company has no plans to change their operating model to sell domestically. Zhejiang Orient Group Home Textiles General Manager Barry Kong reiterated this

sentiment and explained that despite the stable position of his large and well capitalized company, their company's strength is manufacturing and shipping goods abroad, not managing inventory and domestic distribution channels. Even DZ Group executive Song, whose company has experience providing design services, says that the cost and risks associated with building a Chinese brand and selling to Chinese retailers are still too high for the company to attempt expansion into the Chinese market.

Rising Wages Threaten Low Cost Production Model

--- --

¶9. (SBU) For decades, the competitive advantage of YRD apparel manufacturers has been their ability to deliver high quality goods at low prices on a large scale. As the GDP per capita in YRD's major cities rose to several times the national average, to stay competitive, manufacturers relocated production to regions with lower real estate and labor costs. According to Flying Horse General Manager Lu, his company has dramatically increased its outsourcing from 40 percent in 2007 to 80 percent in 2008. Zhejiang Orient now outsources 70 percent of its garment business and 100 percent of its accessory production to lower cost areas in the YRD like Shaoxing and Yiwu. However, outsourcing undermines manufacturer's ability to deliver high quality goods on time. Zhejiang Orient subsidiary Garmtex Vice General Manager Leonard Liu noted that India and Bangladesh are in the process of building capacity with modern factories that offer vertically integrated supply environments that rival those of the YRD. Zhang Tao, who also serves an official role at Beijing based CCPIT Sub-Council of Textile Industry, explained that, despite the shift to outsourcing, labor rates in China have risen to two times wages in Bangladesh and one and a half times wages in India and Vietnam. Although the stimulus has allowed companies to lower costs and survive the economic downturn, rising competition from other countries poses a long

term challenge.

Limited Prospects for Shifting Exports to Emerging Markets

-- -------------

¶10. (SBU) Although the government encourages YRD manufacturers to build sales networks in emerging markets to offset the fall in Western demand, SMEs face a challenge controlling risk in these markets. Flying Horse General Manager Lu explained that counterparty risk is a huge problem for Chinese exporters who are forced to use letters of credit, export credit insurance and other costly financial tools to protect themselves against unknown buyers. Although large companies can absorb these finance fees, the cost is prohibitive for SMEs. CCPIT Hanghzou official Chen Jiyang described one SME who attempted to enter the Russian market. Despite the company's efforts to protect itself by requesting a 30 percent down payment and full payment before shipping, the relationship dissolved when administrative fees wiped out all of the YRD exporter's profits.

Concern that Protectionism Will Limit U.S. Market Share Gains

-- ----------------

¶11. (SBU) Although Seduno Group's General Manager Xu reports that there are "no signs yet" of a recovery, exporters see

potential to capture U.S. market share from other Southeast Asian countries. US safeguard restrictions negotiated in 2005 expired on January 1, 2009. Zhejiang Orient's New Asia subsidiary executive Hu Zhen who oversees sock sales to companies including Walmart, Kohls, and JC Penny, explained how in 2008 he quickly reached his quota of 2 million units. He believes that in a quota-free environment, and with the help of stimulus measures, he can increase his volume to 4 million by undercutting suppliers in other countries. (Note: Statistics from the International Trade Administration (ITA) in the U.S. indicate that this is a growing trend. In January, 2009, U.S. apparel imports fell 6.3 percent, but imports from China rose 7.5 percent to 35 percent of total apparel imports, up from 31 percent in 2008, and 16 percent in 2005. End note.) Xu expressed concern that the GOC efforts to help the textile and apparel industry may lead to a protectionist backlash in the U.S. He is worried that, although the end of safeguards hasn't been as dramatic an event as the end of WTO quotas in 2005 when certain export categories surged 600 percent and prices dropped 40 percent, protectionist policies may limit hopes of gaining US market share.

Additional Stimulus Needed

¶12. (SBU) According to CCPIT Ningbo official Ting, the government's tax rebate and liquidity policies "are keeping companies in business" but he remains anxious for the government to clarify other stimulus programs. Despite CCPIT's close relationship with the GOC, Ting expressed concern about the lack of transparency regarding the industry stimulus plan, explaining that "everything is a surprise, I learned about the tax rebate on television." Ting confirms that for now, businesses remain focused on survival and haven't taken crucial steps toward

operating higher in the value chain or increasing productivity. From the perspective of CCOIC's Tao who tracks the industry across China, although the stimulus "could work to some extent in the short term, we believe that the whole industry will have to solve the problem of overcapacity under the circumstance of decreasing market demand." In recent weeks, the government has announced further stimulus, in the form of plans to help the industry with trade finance and technology upgrades. It remains to be seen how these additional measures will influence YRD apparel and textile manufacturers.
CAMP